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United States Department of the Interior

OFFICE OF THE SECRETARY
WASHINGTON, D.C. 20240

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BY SPECIAL MESSENGER

Honorable Don Young
Chairman, Committee on Resources
House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

I am pleased to enclose responses to questions submitted to the Minerals Management Service as followup to the July 31, 1997, hearing on Royalty-in-Kind issues.

Thank you for the opportunity to provide this material to the Committee. If you have any further questions or need additional information, please let us know.

Sincerely,

Jane Lyder

Jane M. Lyder
Legislative Counsel
Office of Congressional and
Legislative Affairs

Enclosure

cc: Honorable George Miller, Senior Democratic Member, Full Committee
Honorable Barbara Cubin, Chairman, Subcommittee on Energy and Mineral Resources
Honorable Carlos Romero Barcelo, Senior Democratic Member, Subcommittee on Energy and Mineral Resources

ROYALTY IN KIND HEARINGS - JULY 31, 1997
FOLLOWUP QUESTIONS AND ANSWERS

<u>Questions from Chairman Cubin</u>

1. **What is your view on the certainty for lessees delivering the federal share of royalty in-kind, i.e., will the lessee retain any royalty liability to the federal government?**

   One of the primary benefits of royalty-in-kind (RIK) programs is they can offer a dramatic increase in certainty to lessees regarding royalty obligations and liabilities. Conceptually, upon satisfactory delivery of production volumes to the lessor, the lessee is relieved of liabilities concerning royalty valuation. The only remaining, current royalty liability would relate to MMS verification that the delivered volumes and the associated quality of the product are accurate and that any subsequent volume balancing accurately reflects the royalty rate in the lease. Of course, the lessee remains liable for any past outstanding royalty liabilities and any past future operational and environmental liabilities.

2. **Will the MMS support a R-I-K program which requires delivery of the royalty taken at the lease?**

   Our reading of onshore lease terms suggests that RIK delivery would be at the lease, which we would interpret as the point of royalty measurement. For most offshore leases, lease terms allow some flexibility in the delivery point, that is, in-kind takes can either be at the lease or at a convenient point onshore with reimbursement to the lessee for actual transportation costs. Selection of a delivery point under an RIK program may have significant revenue impacts for certain lease/transportation situations, especially with respect to non-jurisdictional pipelines. At this point, MMS has not determined whether under any RIK program offshore production would be taken at the lease or an onshore location. That determination would be made during development of detailed program specifications if a decision is made to implement an RIK program.

3. **As part of the flow of oil from wellhead to a refinery, marketers charge a fee to move the oil, but enhance their value through aggregation of volumes. Why does MMS believe that an oil R-I-K program, aggregating volumes, could not be successful and generate revenue?**

Despite direct questioning, MMS was not provided with information from producers or marketers that aggregating crude oil volumes enhance revenues, beyond what is received from royalties in value. In fact, several producers and marketers stated that price premia are often associated with smaller, incremental volumes of certain qualities that refineries are searching for to fill their capacities. It is our understanding that price enhancements from wellhead to market center reflect a location differential, not a value from aggregation. We will test this attribute in any RIK pilot performed to determine if such enhancement actually occurs.

4 (a). **Industry witnesses testified that there are many companies which make their profits "marketing." Would MMS utilize these experienced marketers in a federal program? If so, how would MMS translate their fees to a R-I-K program?**

(b). **In the 1995 gas pilot, MMS payed a gas marketing fee. Why are you unwilling to pay the fee for an oil program?**

(c). **Why should the MMS restrict the private sector from receiving a commercial return on their added investment downstream?**

In the 1995 pilot, natural gas was sold at the lease by competitive bidding. As such, marketer fees were not paid. Regarding any future RIK program, MMS has not yet determined how the program would be structured.

5. **The cost of transportation away from the lease must be equalized in order for marketers to remain competitive. What are your concerns on transportation?**

Frankly, we have some concerns regarding non-jurisdictional pipeline rates. Gas marketers have stated that, if there is more than one lateral line from a lease, MMS's marketers would probably be able to negotiate between the pipeline owners for the best rate and that competition will bring rates down to reasonable levels. The situation is more problematic for leases where only one non-jurisdictional line exists. The marketers tell us that, if the pipeline owner is attempting to charge unreasonable rates, FERC can assume oversight control and investigate the case, even though they do not officially have jurisdiction. We will be researching this question more in the coming months. The IPAA testified in front of FERC in May 1997 with the same concerns. They were asking FERC to take jurisdiction in such cases.

6. **You mentioned a valuation dispute the State of Texas recently settled with an integrated oil company. Are you aware of the "transportation" rate provided in that settlement? Were marketing allowances given in the settlement? What are your thoughts for using similar rates in a R-I-K program?**

We have heard that the State of Texas recently reached settlement on a royalty issue with a major producer. However, we do not have any details on the specific components and rates included and would defer to the witness from the State of Texas to respond to this matter.

7. **Logic dictates that there should be a reduction in administrative costs under R-I-K. Doesn't that equate to added value to state and federal government?**

We agree that RIK programs should result in administrative savings to both State and Federal Government through a reduced amount of auditing, valuation, and financial report processing. The specific amount of administrative savings would depend on the type and scope of the RIK programs actually implemented. As such, the extent of administrative savings cannot yet be determined.

Several factors would affect potential savings. Administrative expenditures could actually increase in the short-term due to program start-up activities. Further, expected reductions in auditing costs would be deferred for several years as auditors complete reviews of prior periods. Many existing royalty management functions would remain with an RIK program (though they would be at a reduced level), and some new functions would arise. Some of the functions would be:

- Payment processing;
- Distribution and disbursement of funds;
- Volume reconciliations and balancing; and
- Marketer contract administration, or alternatively, marketers and associated staff.

Royalty management functions for the following minerals not under the RIK program would also remain intact and would require staff to operate as currently required:

- All Indian mineral production;
- Solid mineral leases, including coal, sulphur, phosphates, sodium, and others;
- Geothermal leases; and
- Oil and gas leases that do not permit the lessor to take the product in-kind.

Net revenue impacts under RIK programs would be dependent on the interplay of two factors: potential administrative savings and direct revenue receipts. Considering the limitations on administrative savings previously described above, it is our view that direct revenue received for in-kind minerals is by far the most important factor. For example, revenue losses from the 1995 Gulf of Mexico gas RIK Pilot would have been $82 million (extrapolated to the entire Gulf of Mexico for gas production only), far overshadowing any administrative savings possible from the current royalty program whose total budget to administer all lease revenues (including indirect costs) approaches $83 million. Our challenge is to first identify RIK programs that maintain and even enhance our current revenue receipts with minimal risk, followed by designing the details of these programs to provide the fullest extent of administrative savings.

8. **Considering all the litigation associated with today's value system and the delays in collecting what is owed to the federal government, won't R-I-K provide money in your pocket sooner and have the increase of time value of money with it?**

Theoretically, RIK has the potential to decrease disputes, especially over valuation issues. It is certainly in everyone's interest to reduce the administrative burdens, delays in payment, and uncertainty over liabilities associated with such disputes. Our challenge is to ensure that RIK results in revenues that are at least commensurate with those currently received and costs that are less. The amount of revenues that are involved in litigation are relatively minor compared to what we collect. For example, while MMS collects over $4 billion annually in mineral receipts, audit findings typically are some 3 to 5 percent of total collections. It is those audit findings that are disputed and not timely paid. The Federal Government receives interest payments on any audit findings that are not paid timely.

9. **You mention your agency's reluctance to include all gas and oil in a R-I-K program? But, legislation could provide for a staged process with adequate time to bring in different regions. Are you supportive of this type of approach?**

We are not supportive of such an approach. We believe that RIK may not ever be advisable in certain areas and under certain conditions. The lease terms in place provide for an election of in-value or in-kind by the Secretary, and we believe that the Executive Branch should retain that right of election. At this point, it is premature to guess whether any legislative assistance may be needed.

10. It is important to recognize the obvious downsizing MMS would undergo if implementing a successful R-I-K program. I want to work with you right up front to prevent staff reduction from affecting the outcome of the program. Do you have any thoughts on this?

Thank you for your willingness to work with us. Given that no RIK program has been defined, tested, found successful, or fully implemented, it is premature to assume that downsizing would be necessary. For your information, MMS has successfully managed significant decreases in staff consistent with the FTE reductions proposed in the National Performance Review and required by the "Federal Workforce Restructuring Act of 1994" without recourse to reductions-in-force. We are currently in the process of reengineering our Royalty Management Program to integrate the State delegation provisions of the "Royalty Simplification and Fairness Act" and the ability to take royalties in-kind, where profitable. As part of that process, we are also attempting to identify opportunities to franchise services that may require more, not less staff. NOTE

Questions from Mr. Romero-Barcelo

1. **The idea of the Federal government taking, marketing, and selling its royalty share of Federal oil and gas, if done on a national, mandatory basis, is similar to nationalizing our oil and gas resources, particularly in light of how much petroleum resources the U.S. controls. Can you explain to us why this activity is an appropriate arena for the Federal Government to be involved in?**

   We do not yet know if this activity is one that the Federal Government should be involved in, primarily because we have not identified a specific program that meets all of our criteria for success, including revenue enhancement considerations. However, we are not persuaded that the concept of a government taking and selling production is a priori inappropriate. On the contrary, an intelligently-fashioned RIK program could be good business practice and would be consistent with the oft-stated goal of "running the government more like a business."

2. **You have testified that implementation of R-I-K programs would include some risks and that adoption of R-I-K across the board may not be advisable? Specifically, what are some of these risks and what, if any, adverse effects could occur?**

   As a royalty owner, we own the asset--the oil and gas production. Based upon the royalty in-value process, we receive our share of the value the lessee obtains for the product upon disposition. As you know, we collect over $4 billion per year for Federal production under this methodology. We receive nearly all of this without dispute each month-a low risk process for the royalty owner.

   Once the Federal Government as lessor takes that production in-kind, basically the lessee's obligation has been fulfilled The lessor now takes on all responsibilities and risks associated with disposing of the product and being financially rewarded for that disposition. The lessor becomes like an interest owner, but without any control over the production--that is, the royalty production flows as the lessee sees fit. The lessor now bears the costs and risks of transporting, storing, marketing, insuring, and otherwise disposing of the products. Depending on the lessor's performance in these areas, the net revenues may end up being less than what the lessees were able to obtain. Thus, some portion, or perhaps all, of the $4 billion in revenues are put at risk. This is why we are cautiously approaching alternatives to assess what risks we should be adopting on any RIK option.

   Prior to adopting any alternative across-the-board, we would want to see if it makes sense in all areas or whether there are conditions in particular areas of the country that would require a program tailored specifically to that area. With the diverse types of leases that we have from the small stripper wells scattered across remote locations to the large concentration of production in the OCS we want to evaluate alternatives for each particular area and production we are considering. We do not want to create a one-size-fits-all program and then find out that there were situations in an area that the generic program did not fit. Instead, we want to make sure that any pilot or program that we implement is the best alternative for that particular situation.

3. **From the testimony provided today, Mr. Nichols, speaking for independent producers, offered to help design an R-I-K pilot to learn the best way to take royalty in-kind. States have testified today that they support R-I-K with Federal leases within their boundaries. You have testified that the Department is open to alternative and innovative solutions. You have expressed your willingness to work with industry, interested States, and Congress to improve the royalty process. What do you think is the best way to harness this common interest and move forward to answering the questions remaining on making this a workable solution?**

We consistently strive to include our customers in developing alternatives. With respect to RIK alternatives, we have held numerous workshops and listened to the industry and the States, including a portion of the industry we normally are not associated with. We have learned much from this process and will continue to work in an open manner. I have stressed that we want to be cautious in implementing any new program to make sure it is going to work, protect the public's resources, provide the public a fair return on their resources, and perform in an administratively efficient manner. With those caveats, we will continue to pursue those areas that appear to provide the benefits we all seek.

The MMS will prepare the detailed operational and technical requirements for any RIK pilot it chooses to pursue. Once these detailed requirements and program strategies are developed, an analysis of the impacts will be made. Based on these analyses, decisions will follow on whether to proceed with implementation of the recommended pilot programs. Premature legislation would most likely hinder our ability to design, implement, and analyze pilot programs that could result in the most workable RIK programs.

4. **Ms. Quarterman, the Province of Alberta in Canada reports only marginally positive revenue results from its R-I-K program in which marketers sell Crown oil. We understand that this increment results from taking crude from remote areas with few refineries and low demand to areas of higher concentration of refineries and refining demand. How would this dynamic work for the Gulf of Mexico? Onshore? California? Wyoming?**

The Province represented that the marginal increase in revenues is due to the factors you mentioned; however, we have no independent analysis to that effect. At this point, we do not have the data to verify that a similar dynamic would occur for the Gulf of Mexico or other areas in the United States.

There are important differences between the Alberta production environment and that of onshore U. S. production areas--differences that give us pause as we consider RIK scenarios for onshore crude oil. For example, Alberta produces roughly the same amount of crude oil as currently produced from the Gulf of Mexico in a very concentrated, relatively small geographic area with a somewhat limited pipeline infrastructure. The situation is markedly different than onshore in the United States, with its more than 36,000 oil wells, 2,600 operators, and 23,000 producing leases scattered remotely throughout numerous geologic basins in 36 revenue-recipient States. The learning curve for the Federal Government to commence an across-the-board onshore RIK program would be prodigious, and perhaps more complex than the existing in-value system. It seems obvious to us that implementation of a new crude oil RIK system in the onshore environment would be a large and complex undertaking, one that should be attempted only if the revenue and administrative impacts for all parties are substantially positive.

Finally, the Alberta program has an important feature that its marketers cannot also be affiliated with refiners. Although this feature is intelligently designed to avoid non-arm's-length price disputes, it would have the effect of eliminating almost all qualified marketers.

5. **Director Quarterman, the State of Wyoming includes certain stipulations for an R-I-K program, such as the right to receive 50 percent of the gross share of federal oil and gas; the right to market that oil and gas; and the right to receive a cash payment for de minimus payment. Would it be possible for the MMS to set up an R-I-K program with these requirements that would also be revenue neutral and cost effective?**

The States do not currently have authority to separately run a program for their share from Federal leases. The Mineral Leasing Act only authorizes the States to receive a permanent and indefinite appropriation for a fixed proportion of revenues received from Federal mineral leases within State boundaries.

Despite these legal constraints, we recognize that there is significant interest on the part of producers, marketers, and the State to test the potential for crude oil RIK programs in Wyoming. Accordingly, we wish to work jointly with the State to develop a crude oil RIK pilot program to test operational, revenue, and administrative implications of onshore oil RIK approaches. We recently invited the State to join us in this effort.

6. **One of the concerns expressed by independent producers on the crude oil valuation regulation is that because of the way the rule is structured, very few of their sales could be construed as "gross proceeds" thus forcing them to use the NYMEX or ANS as the primary benchmark. This, in turn, would require them to undergo an extensive set of calculations to "net back" to the wellhead. Additionally, they believe that this net back calculation will still force them to pay royalties on a dollar figure that is higher than the amount they are actually selling their oil for. How do you respond to this charge?**

MMS published a supplementary proposed rule in the Federal Register on July 3, 1997, which modified the eligibility requirements for oil valuation for arm's-length transactions. This change allows those producers with true arm's-length sales to pay royalties on that basis. Under the revised proposal, the NYMEX or ANS benchmark would be used only to value a non-arm's-length sale or a sale that hides some of the gross proceeds.

Also, MMS has decided to request additional input on valuation alternatives by holding workshops with our constituents in late September or October. The alternatives will be published in the Federal Register mid September.

7. **How would an R-I-K program accommodate variations in the quality of crude oil, specifically, would MMS be able to market heavy oil? What would it entail?**

In our current RIK feasibility study, we are examining potential RIK programs from a conceptual perspective, isolating those general program attributes that would lead to program success and those factors that would negatively affect a program. Accordingly, the details of how a program would operationally address crude oil quality are not within the scope of the present study. If a decision were made to implement a crude oil RIK program, the quality issue would be a key item to address.

8. **If the industry's R-I-K proposal were adopted, and a mandatory nationwide R-I-K program were adopted, what functions of the Royalty Management Program would remain operative?**

We are unaware of any specific RIK proposal made by the oil and gas industry Tendering all Federal oil and gas to an RIK program would reduce current Royalty Management Program activity. Whether the overall level of activity would be reduced, assuming a full RIK program is put into place, has not been studied. A large portion of the auditing, valuation, and financial report processing would eventually be eliminated or reduced. The reduction in auditing would likely be deferred for several years as auditors complete reviews of prior periods. Many existing Royalty Management Program functions would remain with an RIK program, though many would be at a reduced level. Some of the functions would be:

- Payment processing;
- Distribution and disbursement of funds;
- Volume reconciliations and balancing; and
- Marketer contract administration; or alternatively, marketers and associated staff.

Royalty Management Program functions for the following other minerals not under the RIK program would also remain intact and would require staff to operate as currently required:

- All Indian mineral production;
- Solid mineral leases, including coal, sulphur, phosphates, sodium, and others;
- Geothermal leases; and
- Oil and gas leases that do not permit the lessor to take the product in-kind.

9. **What effect would adopting the industry's R-I-K proposal have on the provisions of the Royalty Fairness Act?**

We are unaware of any specific RIK proposal made by the oil and gas industry. There are potentially some conflicts between RIK implementation and provisions of the Act. Some areas where there may be some conflicts are in the areas of State delegation authorities and taking production from a lease that may be determined to be a marginal property.

We reiterate that we do not support an across-the-board RIK program for all leases and products, or even pilot projects for certain products in specific areas. Much analysis needs to be done before any such conclusion can be reached. Our preliminary analysis, however, indicates that there may be some situations where RIK may be advisable.